

Policy Working Papers

April 1987

Number 2

Is Inflation Really Dead?

by

David I. Meiselman

Director, Graduate Economics Program

Virginia Polytechnic Institute and State University

There have been widespread assertions that inflation is dead. Indeed, many analysts have gone further, contending that we are in a period of deflation. But is inflation really dead?

On one level, if we look back only to 1986 the answer is easy. Inflation has been dead, or close to it, since early in 1986. If inflation is defined as what happens to the general cost of living, say, as measured by the Consumer Price Index (CPI), we find that the index was almost unchanged in 1986, increasing by only about 1% for the year as a whole. The Producer Price Index (PPI), in fact, declined by nearly 3%, giving us some evidence of deflation. A leading actor in the 1986 inflation drama, but by no means the entire cast and script, was the sharp fall in the price of oil during the first half of the year, a price decline that has come to an end, at least for the time being. However, prices of the other components of the Consumer Price Index, including food, but especially services, continue to rise. Only in energy and energy related areas have there been significant price declines or stable prices.

The actual decline in these broad price indexes over much of 1986 may have been the first time this has happened in the lifetimes of some of you. The last time the Consumer Price Index actually fell over the span of a year was in 1949. That temporary price decline was the only interruption in a half century of continuous, uninterrupted inflation that started in the 1930s in the United States, and in virtually every other country in the world. This duration and degree of inflation was unprecedented in the prior 150 years of the 200-year history of the United States, or the 350-plus years if we start with the first English settlements in North America.

In fact, before the current era of inflation started, the price level was close to where it had been when the Declaration of Independence was signed in 1776 and for much of the 1800s. A thumbnail sketch of the inflation history of the United States before the 1930s watershed shows that there was significant inflation only surrounding periods of war. These were offset by periods of deflation after the wars ended that lasted until prices returned to their original levels. This meant that during peacetime years prices trended down. Peacetime deflation was the general norm. So, all in

all, there was no clear tendency for money to lose its value over the lifetime of the typical American and similarly for his bonds, his insurance, his pensions, and the like.

But the old days of secularly stable purchasing power of the dollar ended in the 1930s. To be sure, the upward tilt of the Consumer and Producer Price Indexes, and such other aggregate measures as the GNP deflator, over the past half century, have not been steady and not all prices have been rising continuously. During the past 40 years, since the end of World War II, there have been varying waves of general trends of overall prices, from the 1% to 2% upward drift of the CPI during the first half of the 1960s, to the double-digit increases of 1973 and 1974 and of 1979 to 1981.

Even holding aside special circumstances for specific products which can buck the overall trend (for instance, because of crop failures, changes in government policies, wars, and the like), there are several general regularities worth mentioning, especially about the overall price performance in commodities markets in relation to such broad indexes as the CPI.

First, during periods of low inflation (as measured by the CPI or the GNP deflator), for example, the 1% to 2% per year upward drift from the late 1950s to the mid-1960s, the averages of commodity prices and of many indexes of sensitive prices trended down while consumer prices and wholesale prices drifted up.

Second, when inflation cools off, especially after a period of overheating, (as we experienced starting in 1982 following the double-digit increases in inflation of 1979 and much of 1981), the CPI may be rising, albeit at a slower pace, but sensitive commodity prices may tumble. The price decline, in part, is a reaction to the excesses and dashed expectations of the earlier rapid inflation.

Third, when inflation heats up, commodity prices rise dramatically, and volatility increases as well. For example, in late 1971 the futures price index of the Commodity Research Bureau was at 1967 levels despite an 18% rise in the Consumer Price Index in the 4 years between 1967 and 1971. One year later, by year-end 1972, the commodity price index increased by 35%. By mid-1973, before the oil price explosion that started in October 1973, the commodity price index hit 220% of the 1967 average. By contrast, over the same 1967-1973 period, the CPI increased by "only" 23.8%.

Fourth, when inflation heats up, not only do commodity prices increase faster than the general price indexes for final products (such as the CPI and the GNP deflator), and the price indexes for intermediate products (such as the Producer Price Index), but commodity prices in both futures markets and spot markets become more volatile. There is a similar increase in volatility of financial instrument futures. Increased volatility and the associated rise in uncertainty play havoc with many market participants. But this economic cloud has a silver lining since increased volatility and uncertainty enhance opportunities for profitable trading.

The era of secularly stable purchasing power of the dollar ended in

the 1930s as a result of a series of permanent changes in the old arrangements, especially in the area of monetary affairs. Inflation is a reduction in the value of money, a fall in the purchasing power of each dollar. It is not surprising that the value of money, like the value of other assets, is related to its supply. The greater the supply, the lower the value. Hence, the greater the supply of money, the lower the value of money, which is to say, the more inflation. These average relationships of money to inflation take time to work themselves out. There are significant lags and inertia in the process.

When the U.S. monetary system was on a gold-linked money standard, the link to gold constrained the printing press and the supply of dollars. A dollar was "as good as gold" and "worth its weight in gold," approximately 1/20 of an ounce of it, because the price of gold was pegged at \$20.67 an ounce. Given the link to gold, any spurt of inflation had to be temporary, to be reigned in by the monetary mechanics of the permanent link to gold and to fixed exchange rates that provided the framework of monetary discipline. To be sure, the discipline sometimes gave us other problems, but it did avoid serious inflation.

During the Roosevelt New Deal years, the link to gold was weakened, and then finally abandoned altogether in 1971. Fixed exchange rates were also abandoned as was the gold cover for currency, and similarly, the link to silver was dropped, including silver certificate currency. Essentially, every other vestige of monetary constraint or discipline has disappeared. Now, the Fed, acting on its own or at the behest of the White House or the Congress or whomever, can use its printing press as it wishes. There are no checks on all those monetary balances the Fed can create out of thin air. If you want to dignify this by calling it a standard, it has to be classified as a pure paper standard, sometimes called a fiat standard. There has never been an unconstrained paper standard that has not led to significant monetary abuses and inflation. To label this monetary chaos a standard or system is the economic oxymoron of the century! It is well to recall the words of the great economist, Ludwig von Mises, who wrote, "Government is the only institution that can take a valuable commodity like paper, and make it worthless by applying ink."

The same general story is also true for other countries.

While constraints on money creation were systematically weakened and then eliminated entirely, incentives increased to use the printing press to achieve economic and political objectives--including using money creation to control interest rates, to paper over other financial and banking problems, to finance government spending programs used to buy votes, or to pay for budget deficits. Printing money to pay the bills, at least in the short-run, i.e., before the next election, is often easier than raising and collecting taxes or selling bonds. Richard Nixon's 1972 success in pressing, or inducing into use, the Fed's printing press to influence pre-election economic and financial conditions, a pattern I have labeled, "The Political Monetary Cycle,"* was neither the first nor the last episode where an

*"The Political Monetary Cycle," Wall Street Journal, January 10, 1987, and "Is There a Political Monetary Cycle?" Cato Journal, Vol. 6, Number 2 (Fall 1986).

acquiescent or enthusiastic Fed helped out the White House. Recall that double-digit money growth before the 1972 election led to double-digit inflation in 1973 and 1974, which began before the OPEC oil embargo and price increase that compounded the problem.

These factors have been strengthened enormously by the widespread belief that governments not only have the viable option to use monetary and fiscal policies, particularly expansionary policies, to produce prosperity and full employment in the short-run, but that governments have an obligation to do so. Indeed, not only did a generation of Keynesians and others believe and teach that fine tuning was possible and relatively simple to achieve, they also held that fine tuning was necessary to avoid or moderate business cycles caused by an unstable private sector.

To be sure, while there may be some temporary gains from excess stimulation, this will be at the later cost of both more inflation and higher unemployment than existed before the messy process started. It turns out that when there are marked changes in the growth of money, real effects are felt first and inflationary effects are felt later. Thus, following fast money growth comes the initial good news of more output and employment before the later bad news of more inflation, as the initial real gains in jobs are eroded and replaced by higher prices. For the opposite side of the coin, when there is a restrictive monetary policy, the initial effects are a reduction in output and employment; the secondary effect is a slowdown in inflation. For restrictive or anti-inflationary monetary policies, the bad news comes first and the good news follows. We have never been able to step on the monetary brakes to cure or moderate inflation without causing a recession.

All in all, the inevitable result has been a strong, persistent inflationary bias since the 1930s. When inflation gets out of control, governments step on the brakes, but only temporarily. When memories of past inflation woes dim, as now, vigilance relaxes, enhancing the possibility of short-run gains from starting up the inflationary process anew and thereby also increasing the probabilities of more inflation.

The general monetary environment is, in my judgment, central to the analysis of the general long-period inflationary environment. Within shorter periods of time, even over a year or two, inflation may not precisely track monetary change. The stock of money mainly affects total demand, and there can be short-period changes in the supplies of goods, including changes in the trade balance, or inertia, or changes in expectations, or in the various kinds of uncertainties and contractual arrangements that may temporarily cause changes in money not to be followed quickly and dependably by corresponding changes in prices in the short run. But these short-period deviations from long-period trends typically blur the main underlying inflationary forces, just as movements of the waves temporarily cause the level of the ocean to rise and fall, blurring the overriding effect of the tides. To be sure, short-term traders have to reckon with the waves, but traders can profit handsomely from the tides or be swamped by them. Indeed, even short-term traders ignore the tides at their great peril.

Given these general factors, we have to ask ourselves whether, despite a

slowing or even an elimination of inflation in recent months, there is anything fundamental that has been altered in the framework I have sketched. Despite all the talk about a Reagan Revolution and all the self-congratulation about beating back inflation, it seems to me that there has been no permanent or enduring change in those institutional defects that can contribute to inflation. No constraints have been put on the Fed or on the whole printing press apparatus, nor have there been any changes in the incentives to use inflation for short-run political advantage. Indeed, as we get closer to the 1988 presidential election, there will be a greater payoff to the party in power from making employment and markets look better, even if temporarily, in order to keep the party in control of the White House. With the same constraints (or lack of them), the same incentives, the same institutions, and largely the same players, the probability is high that we will get the same general inflation results, which is to say, significantly more inflation than the experience of 1986. In retrospect, 1986 is likely to look like the temporary interruption in inflation that we previously experienced in 1949 rather than the start of a new noninflationary era. It's tough to get a sustained, significant effect without a significant cause.

There are several factors that increase the near-term prospects for inflation. First, the effect of the oil price decline is temporary and appears to be over. Moreover, another \$15 a barrel decline would give oil close to a zero or negative price--hardly likely. Even another \$15 cut would be a one-shot event, not a continuous process. Indeed, we cannot exactly count on an oil price decline of \$15 a barrel every year. The "generous" Saudis are not about to pay us to take their oil! Moreover, even the rich Saudis would soon run out of cash to subsidize the unlikely process.

To place the oil price decline in context, it is useful to note that energy commodities account for only 6.8% of the weight of all the goods and services in the Consumer Price Index. So, as a first approximation, if all energy were free and nothing else changed, there would only be a once and for all decline in consumer prices of 6.8%, after which the inflation drama would continue playing itself out as before. Moreover, food, including restaurant meals and prepared foods, accounts for 18.5% of the CPI. Omitting food and energy (and energy services), the rest of the CPI, that is, 70% of it, has been rising between 4.5% and 5% per year since 1982, hardly an end to inflation, especially when at a "mere" 5% per year prices double in 14 years!

Even if Republicans had retained control of the Senate, the same general inflation incentives would have prevailed. Indeed, the incentives and opportunities to create inflation are present regardless of who controls the White House, which is why we have had close to similar inflation performance by both parties; double-digit inflation under both Republican Nixon and Democrat Carter, and very low or essentially no inflation under Democrat Kennedy and in the first few years under Lyndon Johnson as well as under Republican Reagan. There are some differences in inflation between the two parties in the first two years of their administrations, but little in the last two years.

Second, consider the preparations for the 1988 presidential election. With Democrats now in control of the Senate, they are better able to carp at a besieged Republican White House. Thus, there is likely to be even greater pressure on the Fed to produce economic and financial magic before November,

1988. When decisions are made, errors will surely be committed on the side of monetary ease, not tightness.

Third, the sluggish, lagged response of inflation to changes in the monetary aggregates saw double-digit inflation continuing after the Fed stepped on the monetary brakes in 1974 and, more recently, in 1981. Now we see the opposite side of the same coin. Over the past year, the M1 measure of money has been rocketing up at 17% to 18% per year making a sham of the M1 target and producing no inflation, as yet. The Fed has dropped all pretense by simply abandoning the M1 target.

Thus, the question which lingers in my mind is the following: Do you know any responsible or knowledgeable person, whose judgment you respect, who would sign his name to the notion that continued 17% M1 growth would not re-ignite inflation? I find it very troublesome that, despite a few quiet questions and murmurs, there is virtually no effective Administration voice, rather muscle, behind any effort or move to slow money growth significantly. If we wait until actual inflation speeds up to slow down the printing press, it will be too late, especially as we get closer to 1988.

Fourth, the trade deficit, which I view as a minor problem at most, is widely viewed as a serious issue. Please note that if the statistics were not gathered and put in their current, largely irrelevant form--irrelevant, that is, for a floating rate world--we would be blissfully unaware that the so-called "trade deficit" exists! Given the wonders of double-entry bookkeeping, the trade deficit of over \$150 billion is exactly matched by \$150 billion of other surplus items in the accounting statement, especially a huge capital inflow from abroad. It is as if foreigners save a larger fraction of their incomes than Americans, use the savings to buy U.S. stocks, bonds and real estate, and also to put up automobile factories in Tennessee, and the like. Foreign savers and investors buy U.S. capital because American capital assets are secure, productive, and profitable--surely this is not a problem. Indeed, for much of U.S. history there has been a similar capital inflow to the United States, increasing the economic welfare of U.S. citizens and of foreign investors as well. Moreover, by increasing the capital stock in the United States, the general level of real wages also ends up higher, not lower, as the misguided protectionists incorrectly assert.

The mirror image of the net foreign savings flow to the United States, the capital surplus, is a corresponding net flow of foreign produced goods and services to the United States, the trade deficit. For those who feel uneasy about deficits, including trade deficits, perhaps we could relieve the angst by referring to capital surpluses, instead.

One effect of the capital surplus (trade deficit) is that we now have about 4% to 5% more goods per year in the United States than without it. So, the inflation rate is about 4% to 5% lower than it would otherwise be. By the same token, interest rates are also lower and securities prices are higher than they would otherwise be. Eliminating the trade deficit, either through fiddling around with foreign exchange markets or by use of trade restrictions, would tend to cause higher prices and higher interest rates, both because of the direct effect of the reduced capital inflow as well as the interest impact of higher

inflation. In any event, these would add to inflation and to the impact of inflation on financial and commodities markets.

The good news is that there seems little chance of an immediate significant reduction in the trade deficit as long as foreigners see merit in investing in the United States because business prospects remain good, and the United States remains a safe haven. The greater danger is that the U.S. will be stampeded into adopting protectionist measures which will surely result in more inflation, higher interest rates and a lower standard of living in the United States.

To sum up, yes, there has been little or no inflation over the past year. No, inflation is not dead, only stopped temporarily. And the main reason inflation is not dead is that essentially none of the major determinants of inflation is much different and none has been permanently changed, despite claims of a Reagan Revolution and despite actual success in 1986. We have been here before, and as the slogan carved in stone on the National Archives Building in Washington says, "What's Past is Prologue."

I have no firm forecast of when the resurgence in inflation will become evident, except that I believe that the standard forecast of 3% inflation for 1987 is likely to be on the low side. For the CPI a safe bet is closer to 5% for 1987, with some chance it may be running even higher by the end of the year--which should be an opportunity as well as a warning!